***United States Court of Appeals***

***for the Second Circuit***


# APPELLEE'S BRIEF

74-1309

IN THE

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

NO. 74-1309

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In the Matter of

UNISHOPS, INC.,

Debtor.

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APPEAL FROM ORDER OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

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BRIEF FOR APPELLEE,

AC&R ADVERTISING INC.

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In the Matter of

UNISHOPS, INC., Docket No. 74-1309

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APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR APPELLEE, AC&R ADVERTISING INC.

## STATEMENT OF THE CASE

This is an appeal from an order of Judge Charles Brieant, Jr. dated March 4, 1974, affirming an order of Bankruptcy Judge Roy Babitt, dismissing a complaint in an action brought by Unishops, Inc.* (hereinafter UNISHOPS), debtor in possession in proceedings for an arrangement under Chapter XI of the Bankruptcy Act, 11 U.S.C. 701, et.seq., by which it

*This action was originally commenced by UNISHOPS in the form of a summary proceeding for injunctive relief brought on by an Order to Show Cause, which Order was entered by this Court on December 13, 1973. On January 7, 1974, at a hearing held pursuant to that Order, the Bankruptcy Judge Roy Babitt ruled that this action is governed by Part VII of the Bankruptcy Rules, that it should proceed as an adversary action in accordance with those Rules, and that UNISHOPS' application for an Order to Show Cause be deemed a Summons and Complaint under Bankruptcy Rule 704.

seeks to permanently enjoin a certain class of creditors from asserting claims against its corporate subsidiaries, even though those corporate subsidiaries are solvent and are not parties to these arrangement proceedings. UNISHOPS seeks to characterize all the claims at issue as claims solely against it and to thereby relegate all the subject creditors' claims to the arrangement proceedings in which only UNISHOPS' assets, and not the assets of its subsidiaries, are at stake. On December 13, 1973, Bankruptcy Judge Roy Babitt temporarily restrained all attempts to assert claims against UNISHOPS' subsidiaries, pending a hearing in the matter. On February 6, 1974, after consideration of Memoranda of Law and argument of counsel herein, Judge Babitt ruled that UNISHOPS had failed to state a claim upon which relief could be granted, vacated his temporary restraining order of December 13, 1973, and dismissed UNISHOPS' complaint, but stayed the effect of his order, pending appeal to the District Court. The District Court, per Judge Brieant, Jr., heard argument on February 26, 1974, and upon consideration of that argument, memoranda of law and the record below, including the decision of the Bankruptcy Judge, affirmed that decision in a memorandum and order entered March 4, 1974, but stayed its order for ten days, pending appeal to this Court.

Appellee, AC&R ADVERTISING INC., a defendant in this action, by reason of its claim against WHITE DEPARTMENT STORES, INC., respectfully submits that the decisions of the

Bankruptcy Judge and the District Court dismissing UNISHOPS' complaint are clearly correct, and should be affirmed by this Court.

## STATEMENT OF THE QUESTIONS PRESENTED

1. Whether the Bankruptcy and District Court Judges committed error in deciding that as a matter of law UNISHOPS' complaint failed to state a claim upon which relief could be granted.

2. Whether the Bankruptcy Judge committed error in not conducting an evidentiary hearing, to enable him to determine whether he had jurisdiction to grant the relief requested by UNISHOPS.

3. Whether this matter should be remanded to the Bankruptcy Judge for an evidentiary hearing, to determine whether the relief requested by UNISHOPS can be granted, with the temporary stay continued in effect, pending such hearing and a final determination.

## STATEMENT OF FACTS

In its complaint, UNISHOPS alleges that all claims against its subsidiaries arising from transactions occurring after June 1, 1973, were solely on its credit and not on the credit of its subsidiaries and hence the creditors have no claims against its subsidiaries. UNISHOPS hopes to prove two factual allegations to support this legal conclusion:

1. That on June 1, 1973, all "divisions" of UNISHOPS advised all "vendors" by letter that in the future UNISHOPS ". . . would purchase all goods in its name and on its credit and would assume responsibility for payment of all trade bills . . ." (UNISHOPS Complaint, ¶4, and Exhibit); and

2. That the method by which UNISHOPS and its subsidiaries operated in the "ordinary course of business", including techniques such as consolidated bookkeeping, the placing of purchase orders by UNISHOPS for delivery to its subsidiaries, and the payment by UNISHOPS for goods shipped to its subsidiaries, was such as to put the trade "on notice that all trade liabilities" were UNISHOPS' liabilities and were not the liability of the subsidiaries receiving the goods. (UNISHOPS' Complaint, ¶5 and ¶6.)

UNISHOPS does not allege, because it cannot, that its corporate subsidiaries are mere shams without de facto corporate existence. At bottom, UNISHOPS' argument is that a claim against one of its viable subsidiaries must be construed by this Court as a claim against UNISHOPS itself, because it contends that as a matter of contract law there can be no valid claims against its subsidiaries and that therefore, this Court has jurisdiction under the Bankruptcy Act to enjoin the prosecution of such invalid claims in State Court.

Appellee AC&R ADVERTISING INC. (hereinafter AC&R) is the plaintiff in an action against WHITE DEPARTMENT STORES, INC. (hereinafter WHITE STORES), an independent corporate subsidiary of UNISHOPS, commenced in the Supreme Court of the State of New York, County of Nassau, on December 20, 1973. That action seeks a judgment of $151,620.07 for goods and services sold, rendered and delivered by AC&R to WHITE STORES, commencing August 1, 1973. These goods and services were sold and rendered in connection with an extensive advertising

campaign carried out for WHITE STORES by AC&R. In its Answer in the instant action, AC&R denies the material allegations of UNISHOPS' complaint. AC&R does not deny that it knew of the basic relationship between UNISHOPS and WHITE STORES, that of corporate parent and corporate subsidiary. But it denies that it was ever made aware of any state of facts which did, or reasonably should have, put it on notice that although it was selling to and rendering services to WHITE STORES, that nevertheless WHITE STORES was not liable to it for payment. But, of course, to determine the correctness of the Bankruptcy Judge's dismissal of UNISHOPS' complaint and the District Court's affirmance of that decision, this Court must assume that the complaint's well-pleaded allegations are true.

## ARGUMENT

## POINT I

### THE BANKRUPTCY AND DISTRICT COURT JUDGES DID NOT COMMIT ERROR IN DECIDING THAT UNISHOPS HAD FAILED TO STATE A CLAIM UPON WHICH RELIEF COULD BE GRANTED.

Under §311 of the Bankruptcy Act, 11 U.S.C. §711, the Bankruptcy Court in Chapter XI proceedings has "exclusive jurisdiction of the debtor and his property, wherever located."

Under §314, 11 U.S.C. §714, the Court may enjoin or stay "suits other than suits to enforce liens upon the property of a debtor, and may, upon notice and for cause shown, enjoin or stay until final decree any act or the commencement or continuation of any proceeding to enforce any lien upon the property of a debtor." The Court's exclusive jurisdiction over the "property" of the debtor under §311 and its power to enjoin suits and collection proceedings under §314 extends only to the kind of property for which title passes to the Trustee upon appointment in bankruptcy under §70 of the Act, 11 U.S.C. §110a. 11 U.S.C. §742, 8, Collier on Bankruptcy (14th ed.1971) §§6.16 and 6.31. See also In Re Panitz & Co., 270 F.S. pp448, 453 (D.Md.1967), aff'd per curiam sub nom; Hammerman v. Arlington Federal Savings & Loan Assn,, 385 F.2d, 835 (4th Cir.1968). No such property of UNISHOPS is involved in AC&R's New York State suit against WHITE STORES.

UNISHOPS does not claim that it owns the assets of any of its corporate subsidiaries, and is, in fact, but a stockholder of each. It is well established that a stockholder of a corporation is not the owner of the corporation's property and that this general rule of law is equally applicable in bankruptcy proceedings. In re Beck Industries, Inc., 479 F.2d, 410 (2nd Cir.1973); In re Goble, Inc., 80 F.2d, 849

(2nd Cir.1936); Linman v. Midland Bank Ltd., 309 F.Supp. 163 (S.D.N.Y. 1970); In re Panitz, supra, at 450-451. Accordingly, since "Congress did not give the bankruptcy court exclusive jurisdiction over all controversies that in some way affect the debtor's estate", Callaway v. Benton, 336 U.S. 132 (1949), the courts have consistently held that the Act does not authorize enjoining a creditor of a solvent and wholly independent subsidiary from prosecuting an action merely because its stock is held by the debtor in bankruptcy. In re Beck Industries, Inc., supra, at 406; In re Gobel, Inc., supra, at 852; In re South Jersey Land Corp., 361 F.2d, 610 (3rd Cir.1966).

By its complaint, UNISHOPS attempts to avoid the application of this well-established rule to it, by alleging that AC&R's claim against WHITE STORES properly should be against UNISHOPS; that there is no contractual obligation between WHITE STORES and AC&R. But this allegation, even if true, is not enough to empower a Bankruptcy Court to grant the injunctive relief sought by UNISHOPS because it stops short of an allegation that AC&R's claim is against property of UNISHOPS; it merely denies the claim against WHITE STORES. Of course, whether or not AC&R has an enforceable contract with WHITE STORES is an issue that the New York Supreme Court is perfectly competent to decide, and is not an issue within

the jurisdiction of Chapter XI, Bankruptcy Court, because WHITE STORES--with its assets--is not before the Court in the UNISHOPS' arrangement proceedings.

UNISHOPS' Memorandum of Law on this Appeal and its Memorandum in the District Court indicate that the flaws in its complaint are now also apparent to UNISHOPS. In its Memoranda, UNISHOPS has expanded its original claim and now contends that because suits such as AC&R's could lead to a state court judgment which in turn might be executed against some UNISHOPS' property in possession of WHITE STORES, that therefore the Bankruptcy Court has jurisdiction to enjoin such suits. But this new view of UNISHOPS' allegations does not save UNISHOPS' complaint from dismissal. Section 314 of the Bankruptcy Act, 11 U.S.C. §714 provides the only procedure necessary and proper to protect any property of UNISHOPS "wherever located" from any misdirected execution pursuant to a judgment against WHITE STORES. In the unlikely event that AC&R should attempt to execute a judgment against WHITE STORES on property that is not owned by WHITE STORES but by UNISHOPS, the Act would authorize the Bankruptcy Court ". . .upon notice and for cause shown to enjoin. . . any act or proceeding to enforce any lien upon the property of . . ." UNISHOPS.

The futility of UNISHOPS' attempts to carve out an exception to the general rule is clear when its contentions are viewed in light of this Court's decision in In re

Beck Industries, Inc., 479 F.2d 410 (1973); cert. denied, 414 U.S. 858 (1974). In that case, the debtor-parent corporation did not contend merely that the suit against the subsidiary was against the wrong corporation, but it went much further and alleged that the suit against the subsidiary was a suit against the parent because the subsidiary had no separate existence that the law should recognize. The issue on appeal was whether the subsidiary was a separate legal entity. This Court reversed decisions of the Referee and the District Court, which both had found the subsidiary's independent corporate status to be the "sheerest fiction", and stated:

> In short, absent proof that subsidiary was a mere sham or conduit rather than a viable entity, the (State Court) suit is not "a proceeding to enforce a lien upon the property of the debtor" as that phrase is used in §516 of the Bankruptcy Act and the Bankruptcy Court therefore lacks jurisdiction.
>
> In re Beck Industries, Inc., supra, p. 416.

Likewise, AC&R's state court suit against WHITE STORES is not a proceeding against UNISHOPS or UNISHOPS' property and, because UNISHOPS has not even claimed that it is, the Bankruptcy Court has no jurisdiction to enjoin that state court action.

As Judge Brieant stated at Page 10 of his decision below:

> Simply because persons properly creditors of the parent may be minded to present their claims in state court against its subsidiaries (claims which

> are merely colorable and with respect to which the subsidiary may have a full and complete defense because the goods were in fact sold on the credit of the parent, and not the subsidiary) is not a basis for this Court to reach out and inject itself into the business of the state courts, which are being asked to determine actions between operating subsidiaries which are not bankrupt and persons claiming, albeit falsely, to be creditors thereof.

Indeed, appellant's theory not only would have the Bankruptcy Court inject itself into the business of the state courts, but would have it do so even though it lacked control over the subsidiary and its assets. Such a result is clearly inconsistent with the plan of the Bankruptcy Act because it denies to the creditor any assurance that its claim against the subsidiary will be of any real value once the Bankruptcy Court adjudicates its validity. The fundamental wisdom of the Beck Industries decision is that it limits bankruptcy jurisdiction to claims against legal entities and assets that are fairly within the control of the Bankruptcy Court. A finding that a subsidiary is a sham perforce means that its assets are subject to the Bankruptcy Court's jurisdiction as assets of the bankrupt parent. The illogic and basic inequity of UNISHOPS' position is that it would have the Bankruptcy Court decide the validity of claims against assets that are clearly not before it, because the claims are against admittedly separate legal entities. The Court might well be making decisions it could not enforce and forcing claimants to litigate the same claim twice; first as defen-

dants and then as plaintiffs. The underlying fairness of the Bankruptcy Act will be preserved only if UNISHOPS' novel theory is rejected and the dismissal of its complaint affirmed.

## POINT II

### THE BANKRUPTCY JUDGE DID NOT COMMIT ERROR IN REFUSING TO CONDUCT AN EVIDENTIARY HEARING ON THE JURISDICTIONAL ISSUE.

It follows from all that is stated in POINT I that the Bankruptcy Judge had no need to take evidence because on its face, UNISHOPS' complaint did not allege that the claims made against its subsidiaries were claims against it. The complaint was properly dismissed as a matter of law.

## POINT III

### THERE IS NO NEED FOR A REMAND TO THE BANKRUPTCY JUDGE FOR AN EVIDENTIARY HEARING TO DETERMINE WHETHER THE RELIEF REQUESTED BY UNISHOPS CAN BE GRANTED.

UNISHOPS has persistently contended herein that the broad policies of the Bankruptcy Act are adequate to fill the gaps in its complaint. UNISHOPS pleads that if suits against its admittedly viable independent corporate subsidiaries are permitted, its efforts to rehabilitate itself will be frustrated and the plan of the Bankruptcy Act undone, because it will be forced to litigate these claims in widely diverse courts and jurisdictions. But, as this Court stated in Beck Industries:

> . . .this argument puts the cart before the horse. The corporate veil cannot be disregarded merely because it would make for 'an efficient and economical administration' of the debtor's estate. . .
>
> (Citations omitted) Id., at 419.

It is respectfully submitted that UNISHOPS has yet to offer any discernible reason why the relief it seeks should be granted other than that such relief will permit a more convenient and economical management of its legal and financial affairs. Under the circumstances, only this Court's affirmance of the decisions of the Bankruptcy Court and the District Court, dismissing UNISHOPS' complaint, will truly preserve the spirit and the letter of the Bankruptcy Act.

## CONCLUSION

THE ORDER OF JUDGE BRIEANT AFFIRMING THE ORDER OF JUDGE BABITT SHOULD BE AFFIRMED AND THE STAY OF THAT ORDER DISSOLVED.

Dated, New York, N.Y.
March 13, 1974

Respectfully submitted,

TAYLOR, FERENCZ & SIMON
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BY: _____
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